RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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August 23, 1978 **LETTER 737**

Aug. 11, DJIA 890.94; PTI 899; A-D Ratio –16.23
Aug. 18, DJIA 896.83; PTI 910; A-D Ratio –15.79

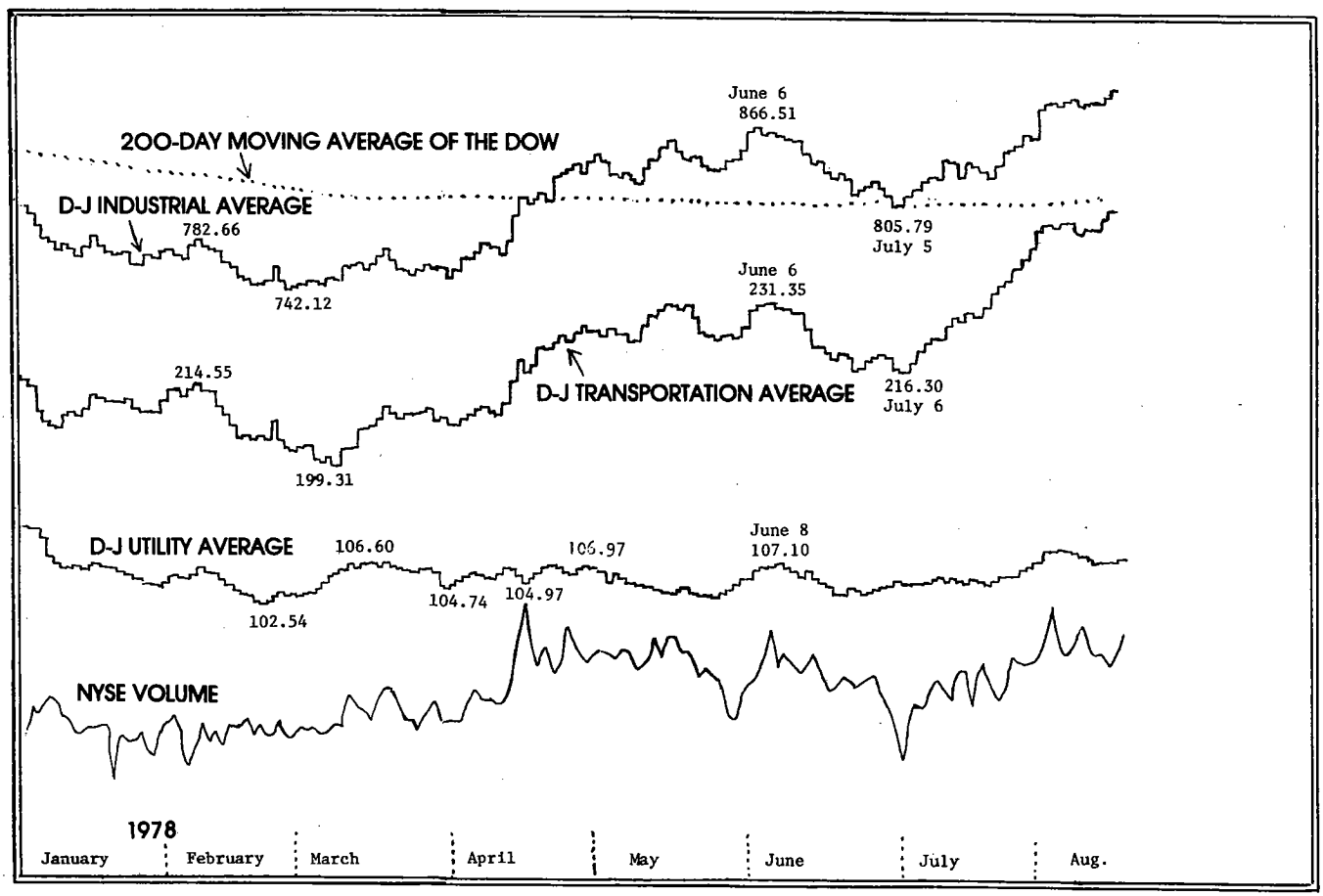
OUT OF CONTROL: Many months ago I wrote that 1978 could well be the year when the markets went "out of control." I believe that is what is happening. In the last Letter I stated that "the spectacle of bonds, gold and stocks all going up is a great rarity. This 'dance' of the three enemies will not continue."

Already there have been minor but violent interruptions in the upward dance. The bond market broke sharply last week, then recovered part way. On August 17 gold dropped $5 from its record high, then it too bounced back part way. The stock market turned erratic as well. On August 17 the Dow spiked up 12 points intra-day to well over 900, then sold back to 900 on the closing. On August 18 the Dow rallied again, then closed below 900.

Why all the hysteria? Why so frantic to buy, why so quick to sell? The answer lies in the acceleration of the inflation factors, and the chance, just the dim chance, that the Administration may try to step ever so slightly on the monetary brakes. On August 17 President Carter, in response to complaints, pleadings, threats and demands from our overseas creditors (dollar holders), gave one of the weakest, most insipid and vacuous speeches in political history. Mr. Carter's answer to inflation was that he was asking for advice. Sensing the disappointment with the Carter non-speech, Treasury Secretary Blumenthal immediately saw fit to announce that the Administration would take various anti-inflationary setps over the coming weeks. On August 18 the Fed boosted the discount rate ½% to 7¾%, but belatedly following the lead of the money market. The move was generally expected, but despite all expectations it must be noted that the discount rate has been higher only once before in history (the discount rate hit a record high of 8% in 1974).

In the last report I showed why the administration is terrified of recession. It is clear that the Administration would be perfectly willing to accept inflation if only Europe and Japan would leave them alone. But the statistics are almost frightening. The "fuel" of the banking system, the fuel that turns into monetary energy, is now exploding. Non-borrowed reserves have increased (annual basis) at a rate of over 15%. The monetary base has expanded at an annual basis of 12.6%. Total bank reserves have expanded at a 30.8% rate. This means that the money supply will soon boom. In short, the Fed and the Administration will (by the fourth quarter) be faced with a veritable monetary explosion. On this basis, interest rates can be expected to surge still higher by the end of the year or early in 1979.

STOCK MARKET: My own guess is that the stock market is being fueled by heavy foreign buying. Foreigners are holding just under $100 billion of US Treasury obligations. They hold tens of billions worth of various other US bonds. These same



foreigners have been quietly watching their assets in the bond markets go down the drain. If you are a German or a Swissman or if you are Belgian or Japanese it must be quite an experience to see your assets evaporate in front of your eyes (in terms of your own currency) as the dollar hits the down escalator. But the US stock market gives you at least a chance to recoup your losses. And with the market heading up you are frantic to get in on some of the action. After all, hasn't everyone said that US stocks are the only area in the world that have not been pumped up by inflation!

We know that the funds were not buyers during the second quarter of 1978. But there is a limit to how long the funds can or will stay out of a rising market. A fund manager can face a crash, he can face dullness, he can face losing large portions of clients' money. But they will not tolerate being out of a major market rise. On that basis, the funds (pension, institutional, etc.) may top off this wildly speculative rise with a plunge into the market. If so, we could see an updated version of 1929 (and I believe we've seen quite a bit of 1929-type action already).

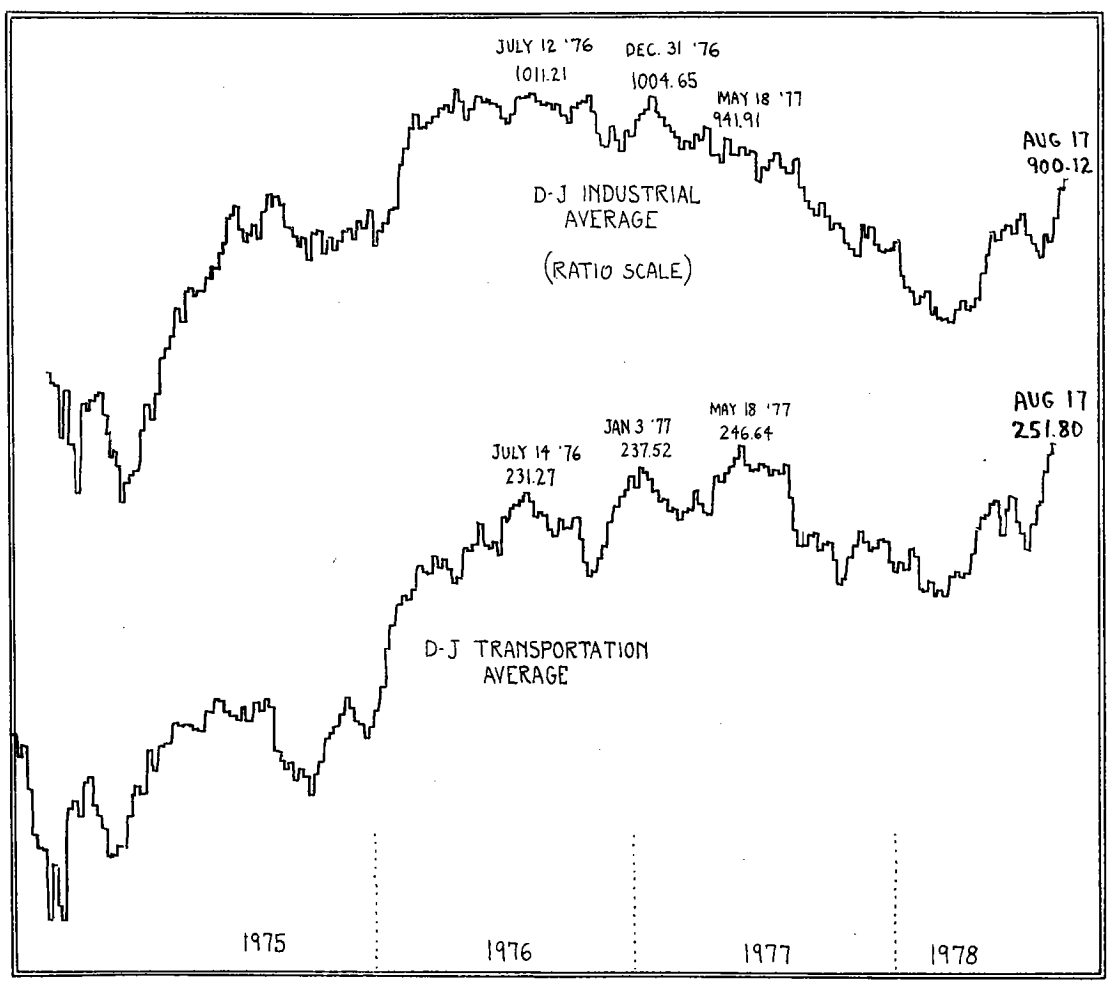
THE ACTION: I don't believe I've ever seen a more speculative and (in my opinion) dangerous market. The market now has six discount rate boosts to contend with. The market has a record $11.2 billion margin debt under it. The market has huge forthcoming Government financings (in the bond markets) to compete with. But in many previous Letters I've listed the factors that make this a scary market.

So let's turn to some of the *technical* aspects of this market. From the standpoint of the Averages themselves, there is a phenomenon that I have not discussed for a while. But it is a matter which should be updated. This chart traces the weekly action of the D-J Industrials and Transports from the 1974 lows to the present. Note that the last CONFIRMED highs in the two Averages occurred in mid-July, 1976. Since then we have witnessed a period which I label as the longest divergence sequence in the history of the Averages.

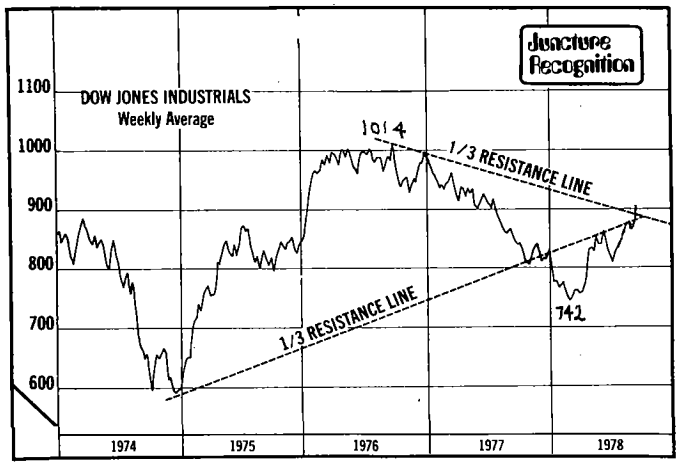
The Transports since their July 14, 1976 peak of 231.27, have continued to push up, recording three more new highs: January 3, 1977 at 237.52, May 18, 1977 at 246.64 and most recently August 17, 1978 at 251.80. Against this series of new highs, Industrials have recorded an extraordinary series of declining peaks: July 12, 1976 at 1011.21, December 31, 1976 at 1004.65, May 18, 1977 at 941.91, and most recently August 17, 1978 at 900.12.

What is the meaning of this amazing series of divergences? Robert Rhea, the great Dow Theory master of the 1930's, stated that divergence in the Averages, particularly when accompanied by high volume, indicated distribution. Certainly since July, 1976 we have had divergence in the Averages. Most certainly we have had high (actually record) volume. As of this writing the divergence remains in force. And I wonder whether the Averages in their own way are not providing us with a long-term indication of danger.

A most interesting study is the action of the Dow in relation to the speedlines (the speedline concept was first formulated by that remarkable analyst, Edson Gould). The accompanying chart (page 3) shows two major speedlines, one extending from the 1974 low and the other from the 1976 peak. I am not going into the actual construction of Gould's speedlines. But suffice it to say that these major speedlines offer strong resistance to the Dow on any further advance. However, a speedline, once bettered, acts in reverse, and the resistance then becomes support. Note that both speedlines pictured on the chart converge at the 900 level. For this reason, I feel that the market is in a critical area. If the Dow can close decisively above 900 (above the two speedlines) then we could see a sharp upward "spike" and in that case I would think we were witnessing the final speculative "blow-off" for this rise. But if the Dow cannot better the 900 level, then my feeling is that the trouble is about to start. In that case, my eyes would be back on the 878.45 level. Breaking 878.45 (the halfway level of the 1976-78 decline) would put the whole advance in jeopardy. (Chart courtesy of *Juncture Recognition*, Box 1209, Pompano Beach, Fla. 33061).



I also pointed out in the last Letter the importance of the halfway level (878.45) of the entire 1976-78 decline. On August 2 the Dow closed



above the 878 level, which was a big plus. In the last Letter I stated that "I am most interested to see whether the Dow can hold persistently above the 50% level of the last major decline." I repeat that the ability or inability of the Dow to hold above 878 will provide an excellent indication of the next broad swing of the market.

On the plus side: my mechanical "fail safe" indicator,. the Dow moving averages, has crossed over to the bull side. On the week ending June 29, 1978, the 13-week MA of the Dow crossed above the 50-week MA. The bullish crossing cancelled the major bear signal of November 26, 1976. At present the 13-week MA stands at 848, while the 50-week MA is at 816. Thus the 13-week MA is 32 points above the 50-week MA, and both are now moving up (the 50-week MA turned up on the week of August 3, and is now rising at the rate of about 1 point per week). On the basis of this study, I recommended a limited trading selection of common stocks in the last two reports.

Question: Russell, what do you think has been happening in the markets?

Answer: I'd say that the US market is responding to two unusual factors. First, I think the investors thought that they'd seen the "top" for interest rates. Second, I think we're seeing a *flight in the US* (and in other markets) *from paper*. I'm including this chart (courtesy of *International Capital Perspectives*, Geneva, Switz.) which shows the rate of growth in the money supply of major producing nations. We already know what the US is doing with their money supply, but most people are shocked when they learn that the **whole world is inflating.** The heavy black lines on the chart represent M-1, and in every case the money supply has been rising at 10% or better. In view of this, it's hardly a surprise to see gold moving up against paper.

Question: Why have currencies like the German mark and the Swiss franc been able to keep up with or even outperform gold?

Answer: The mark, the yen and the franc have stayed in line with gold basically because they have been so much stronger than the dollar. Germans, Swiss, Japanese **didn't have to go to gold**, because they could just stay in their own currencies and watch the dollar drop out of sight in terms of their own currencies. BUT, in view of the boom in the money supplies of ALL nations at this point, I think we are nearing the time when the whole world is going to start hoarding gold. At that point, gold will outperform ALL currencies.

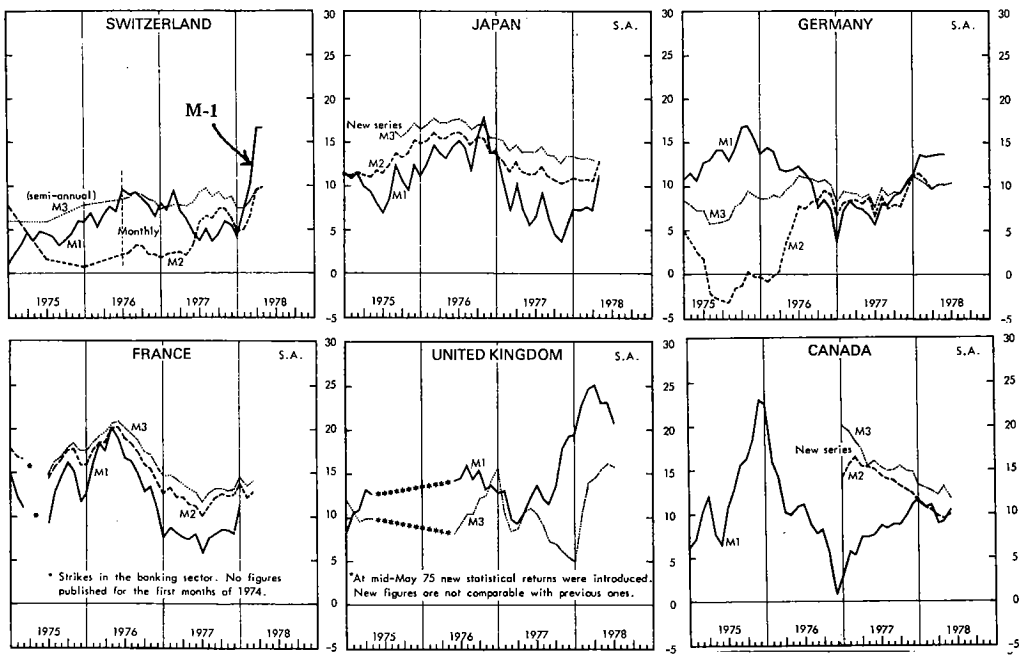
Question: Do you really think US interest rates have topped?

Answer: I do not! I think that within a year (and probably a lot sooner) we are going to see new highs in interest rates. The big squeeze has yet to come.

Question: If there's a flight from paper "money," why are the various commodities performing so sluggishly?

Answer: That's a tough one. The fact is that grains and meats are sluggish to mildly bearish. Copper is "nowhere," and copper is normally a good economic barometer. And even silver is a disappointment. The commodities are not only subject to inflation, they are subject to forthcoming supply-demand conditions. I can only think (at this time) that the commodities are not "seeing" any kind of economic boom ahead. They are being affected positively by the flight from paper; they are being affected negatively by what traders must perceive as sluggish business conditions in 1979.

My own belief is that we are going to see recession creep in before 1979 is over. The consumer is now choking on debt.



His average rate of savings is now the lowest in 14 years, and the ratio of consumer debt to disposable after tax income is near a record high. When the recession comes, there is going to be a squeeze on prices as the consumer cuts back drastically on spending. But the Government's knee-jerk reaction is going to be more spending. Thus a recession could bring about price deflation (a drop in the price of goods) plus monetary inflation (a drop in the international value of the dollar). All this the commodities could be discounting.

Question: What's wrong with silver? Why isn't it keeping up with gold?

Answer: As you know, I've never been a big silver buff. Silver is not

Barreling In

Oil Imports Are Rising After First Half Drop; Record '79 Total Likely

Industry Inventories Pared Need for Imports Briefly; Strategic Reserve's Effect

But Some Conservation Seen

By JAMES TANNER
Staff Reporter of THE WALL STREET JOURNAL

On the surface, last month's news seemed favorable: Oil imports, a key villain in the huge U.S. trade deficit and the sinking fortunes of the dollar, were about 13% below

a monetary metal–no central bank in the world holds silver. I think that silver will act more and more like a commodity subject simply to supply and demand. And right now silver is being pulled up somewhat by gold and being dragged down somewhat by the blah commodity performance. In case of a world deflation or a period of monetary chaos, I believe silver would go down with commodities, rather than go up with gold.

Question: With the dollar still weak, do you see any kind of turnaround in the near future for the greenback?

Answer: The dollar has been going down hard ever since late-1977. It's probably over-sold now and due for a rally or at least a spate of stubborn holding action. After all, the dollar's not going to zero in 1978 or 1979. The yen and the Swiss franc have spiked up against the dollar. On the charts they look as if they've "blown their tops." Thus, the dollar could have a respite. But so far, I see no bullish fundamentals for the dollar. The nation is still spending its head off, the country is still totally consumer oriented, and the question behind every labor strike is "how much of a raise will we get?" (In the "old days" it was usually a question of whether a raise at all). The trade situation and the balance-of-trade figures are discouraging. In fact it's downright depressing to note (see WSJ clip) that our oil imports are rising again and could go to record highs in 1979! Therefore, I see nothing fundamental to turn the dollar.

Question: Russell, you drew our attentions to the bond market, and you said that your signal for a bull move would be the Treasury 8's of 1996 moving just above 94. This happened, and I note that those bonds are now about 95. Do you think the bond rally is going to continue?

Answer: I see the bond rally as a movement (technical in nature but long overdue) AGAINST the primary trend of bonds–which is down. The bonds had been going down ever since January, 1977. On top of that, the Administration had been pressuring the Fed to ease up on the money picture. The Fed literally stepped aside and "let it all run." The monetary aggregates are booming, and, of course, this spurred both inflation and the stock market.

Question: I don't understand the Fed's thinking or the Administration's thinking. Why have they let the money supply run out of control–even in the face of high inflation?

Answer: I tried to answer that in my last Letter. The Administration is deathly afraid of the next recession, and they've been pushing it off as far as possible–at the expense of the dollar. The reason the Administration is panic stricken about recession is that they know that the deficits which will be produced will be of unbelievable proportions. Yet there is another factor which militates towards US inflation now. The accelerating inflation is producing less and less in the way of real GNP. Inflation is so intimately built into the US economy that IF THE INFLATION RATE FALLS OFF, the results would be deflationary! In other words, we could get recession just by letting the inflation rate trail off.

THE "CENTER" AND GOLD: All life gravitates towards the "center." Schizophrenics are split, they cannot get in touch with their center, and thus they are insane. Some people are obese and some are emaciated. But civilization's standard of beauty (or normality, if you wish) tends towards the center, the average body build. College students when I went to college were quiet and careful. Nobody knew they existed. Twenty years later college students were burning down the campuses and raising clenched fists (during the 60's). Now students are moving towards the center; they are relatively quiet, yet still vocal. A certain normality has crept over American campuses.

In the financial world today, **the center is missing.** The missing part is a stable money standard. The dollar, the centerpiece of the world's monetary reserves, is now a wobbly piece of printed green paper that has now fallen to its lowest level in years. The dollar thus reflects the results of a 40 year swing of increasing inflation, increasing deficits, increasing spending. With the financial center literally "shot away," investors find themselves in a truly schizophrenic world. Today the investor has to think not in terms of profits but in terms of preservation. "The Battle for Investment Survival" has become simply the battle for survival.

In the financial and economic world, we're looking at ONLY TWO ALL-TIME HIGHS at the present time. One is DEBT, the other is GOLD. We're very used to new highs in debt; we're not used to new highs in gold. Gold at "over 200" is comparable to the Dow if it was at 1200. No one has ever seen gold at above 200, and naturally they're suspicious. Yet with gold now being actively purchased by many nations (including the less-developed nations), there's only one country in the world that is fighting the rise in gold. That country is the US. But the primary trend of gold, the tidal force that took gold to a record high a few weeks ago, that primary trend is stronger than President Carter, the Congress and the US Treasury combined.

As gold rises in price it swells the real reserves of many central banks. It also provides many nations and individuals with a hedge against the falling value of the dollar. New highs in gold also attracts the eyes of the little man, the storekeeper, the baker, the housewife, the person who is capable of buying perhaps a coin or two with each paycheck. Already almost 25% of S. Africa's gold output is going into coins. I see this ratio rising as the world "paper blizzard" continues. You can fool all the people just so long. The US has hoodwinked its citizens about the "barbaric relic" for the last forty years. Yet with all its campaigning, with all the billions it has cost the US to fight gold, here is gold at historic highs. The little man may not learn fast but he is no fool. He will protect himself when he learns the proper defense. The proper defense is gold.

Gold rose to a record second London fix of 215.75 on August 16. It did so on no special news. It did so contra-seasonally (gold is usually soft during July and August). In the face of continuing skepticism, gold will have to convince people that it means to "stay around or above 200." The 50-week moving average of gold is now 174. The 13-week MA is now 191. The 4-week MA is 206. If gold can near 200, consolidate, back-and-fill, hold, it will have achieved a huge technical plus.

Gold has climbed above the 200 level on a "wall of worry," and the climb away from the 200 level will be no easier. It is hard to sit with any item through a full bull market, and I guess the only way to do it with gold is "the Pick way." As Dr. Franz Pick once said, the way to operate with gold is to use your behind. You buy gold "and then sit on it!" I think he's right.

That entails buying the coins or the bullion and holding it through the warnings and the reactions and the bearish forecasts. Gold is real money and dollars are the liabilities. When we finally sell our gold, it will probably be for some form of paper. At that time, we better be damn sure that it is good paper. And dear readers, we just ain't there yet!

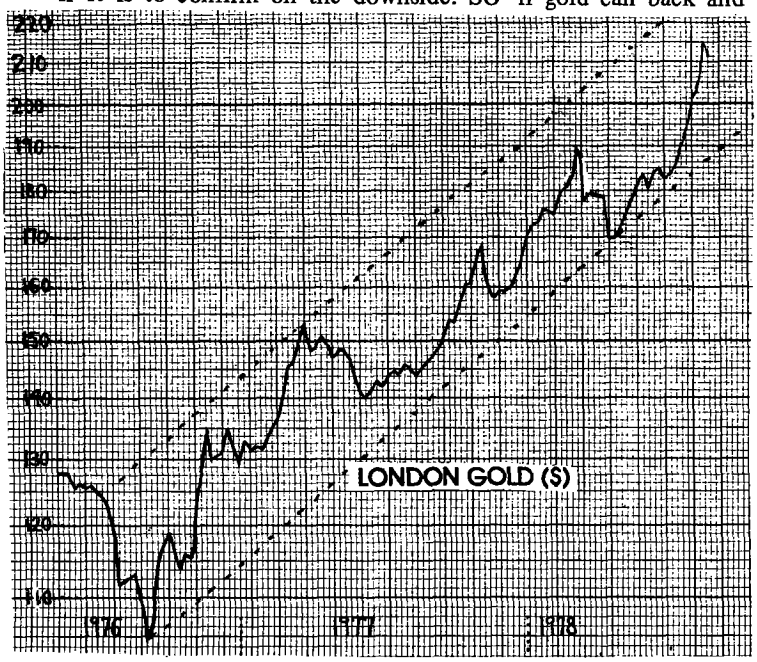
I want to make two points clear, if I can. (1) If an investor holds 20% or 25% of his assets in gold, he should not sit around hoping that gold "goes through the roof." If gold goes up, fine, but if it doesn't, well that's the cost of insurance and don't begrudge it. The fact is that if gold goes to 300 or 400, we know that the dollar will have depreciated accordingly (as an inverse function of gold). So if gold booms, the dollar is collapsing, and that's hardly something for Americans to celebrate.

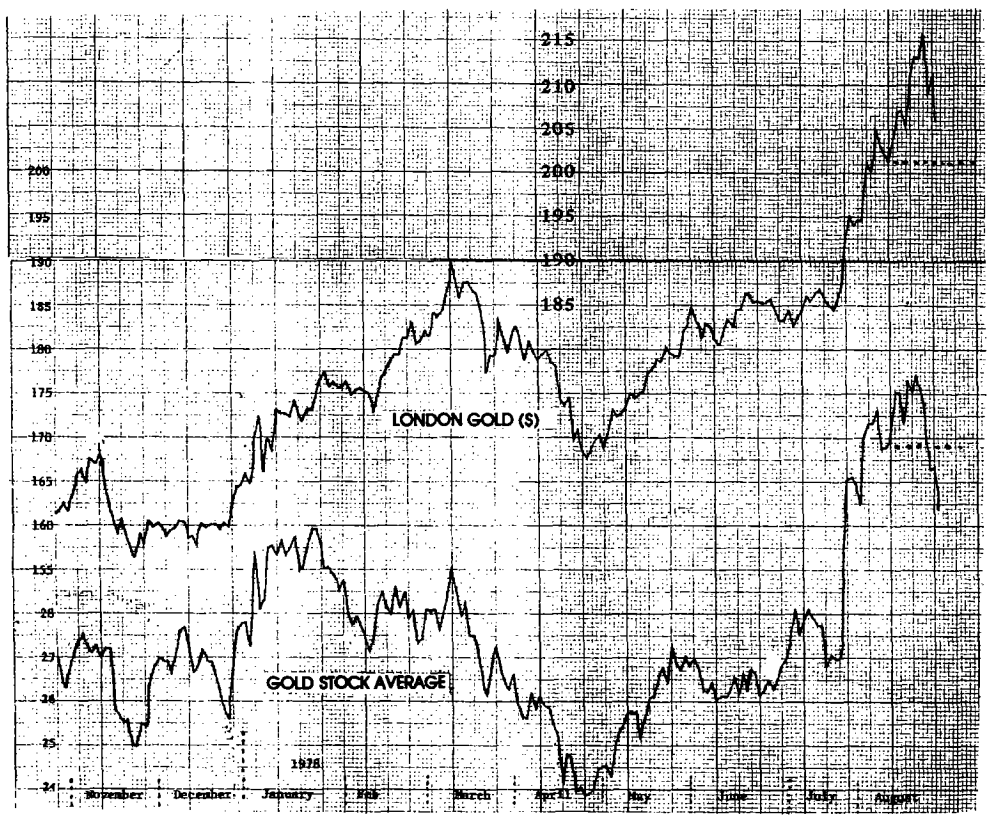
The *repercussion* of the massive dollar decline during the last year has not yet been seen or experienced fully. A further big decline in the dollar (in terms of gold) would be a tragedy, an ominous tragedy. So I will tell readers again to treat your gold as an insurance policy. The wise man would buy gold and secretly hope that it never goes up.

Second, gold futures are a rank speculation, not an insurance policy. You don't invest or take long-term insurance with a margined future. Futures are for trading, and those who have "played" the futures game know how hard it is. Incidentally, I just received a new, excellent booklet (soft cover, only 64 pages) by my friend R. E. McMaster. The booklet is a much needed "notebook" for traders and that's just what it's called, "Trader's Notebook." The price is $50, which is high, but the book is a gem, so to my way of thinking it's cheap. If interested, write The Reaper, PO Box 39026, Phoenix, AZ 85069.

I'm including (bottom of page) my daily chart of gold and the gold average (GA). I've said before that confirmations and non-confirmations on the part of these two can be most revealing. Note, for instance, how the non-confirmation by the GA in early March brought about a big slide. Then note in April how the non-confirmation by gold tipped the big rise (and I wrote about this at the time (Letters 726, 729).

Last week a minor non-confirmation appeared. The GA broke below its early-August low (dotted line) but so far gold has not confirmed. Gold would have to drop below 201 (dotted line) if it is to confirm on the downside. SO–if gold can back and

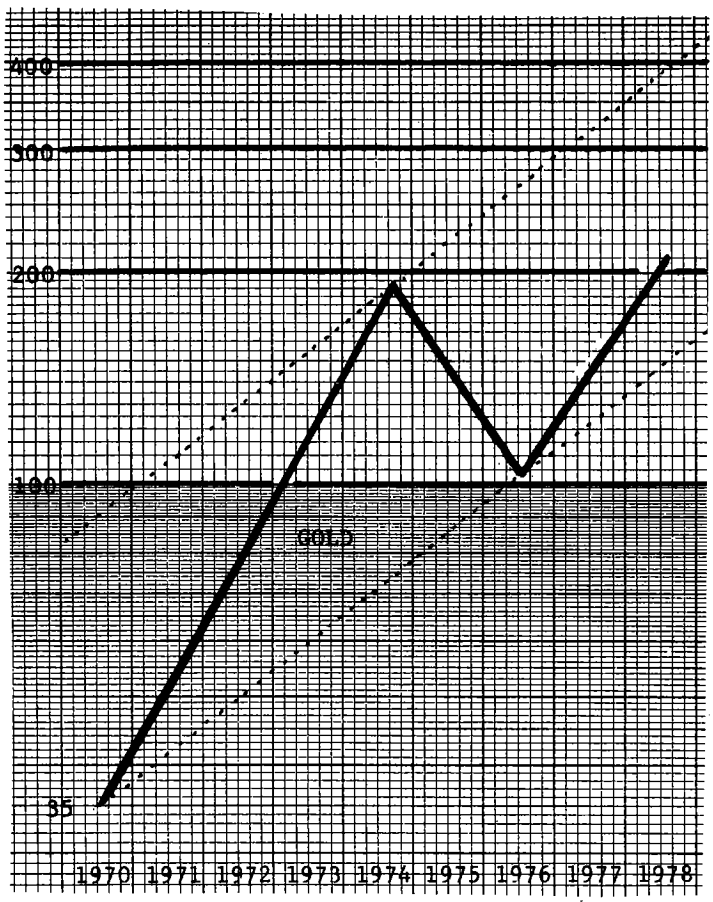




fill but hold ABOVE 201 the non-confirmation will hold in force. IF so, gold should go to new highs in due time.

I've redrawn (above) the channel within which gold has been rising since August, 1976. The upper trendline of the channel is now about 240. The lower trendline comes in at about 195. If gold is to remain relatively "orderly," it will tend to remain within the rising channel. This chart is composed of each Thursday's second London fix.

FIGURING: I have drawn (page 6) a simplified chart showing the three main swings in gold since its 1970 "official" price of $35 per ounce. There is a tendency for the price movement (any price movement) to resist at the basic even numbers and also to support at the basic even numbers. By basic numbers I mean 1,2,3,4,5,6,7,8,9,10 and multiples of those numbers in tens.



Thus, a stock will rise from 3 to 9 7/8, resist, drop back, try again. If the stock can better 10, then hold decisively above 10, it will (in due time) usually try for 20. If the stock can not better 20, it will often drop back to 10, where there will be strong downside resistance. If it can hold 10, it will try for 20 again. If it can better 20, it will try for 30.

In view of this, let's examine the gold movement. From 35 in 1970, gold rose to 197.50 in late-1974. But gold was unable to better the 200 level in 1974. From the 197.50 high, gold sank back towards the 100 level again. On August 25, 1976, gold hit a second fix of 103.50. But gold (despite dire predictions of "back to 35 again") held stubbornly above 100.

The next major swing took gold back to the highs to test the 200 level. On July 28, 1978 gold finally hurdled the 200 barrier. If gold can hold decisively above 200, the next stage of the drama should be ready to unfold.

The accompanying chart is drawn to ratio (percentage) scale. I have drawn a trendline connecting the 1970 and the 1976 lows. I have drawn a parallel trendline intersecting the 1974 peak. In due time the bull market in gold should approach or make contact with this upper trendline. This would be a normal occurrence in a bull market, and it doesn't matter whether the item is gold or a stock or hog bellies.

With gold above 200, it would also be normal for gold to try for the next even number level, which is 300. But significantly, the ratio chart shows that the percentage rise from 103.50 to 200 is approximately the same as the distance from 200 to 400. It would not be unusual to see a percentage move from here which would, in due time, equal the move from 103 to 200 (a move that would, at the same time, come in contact with the upper parallel trendline).

In this analysis subscribers should remember that I am not dealing with time; I am dealing with price levels. But at this stage of the game, the gold bull market can be expected to accelerate and thus the action from here should be faster than the action which preceded. I also want to remind subscribers that the foregoing is a theoretical discussion, not a promise. But it is based on my own experience with the price movement.

LATE THOUGHTS: I think there's a good chance that the hard currencies (franc, mark, yen) are in the process of at least *temporarily* topping out against the dollar. I note that since April gold has been slowly moving UP in terms of Swiss francs. If the dollar advances against the hard currencies, holders of those currencies could start buying gold. For this reason, I'm watching the hard currencies carefully.

Bulls on the stock market are now everywhere. A lead article in the August 21 *Barron's* openly predicts a 1300 Dow. Maybe so. I note that from the February 28, 1978 low, the Dow rise has taken the form of an A-B-C pattern. The A-B-C breaks down into a 5-3-5 Elliott pattern (5 sub-waves up, 3 sub-waves down, 5 subwaves up). The last sub-wave could carry higher, but in form, at least, we have a perfect outline for an Elliott upward **correction**. The whole structure would start breaking down if 875 were hit on the Dow, but more importantly 865. Those figures would break trendlines which extend up from the July low.

We had our 6th consecutive discount rate boost last week. No market has ever before survived such a series. It took only four discount rate boosts from Feb. 1928 to August, 1929, to kill that market. The discount rate was raised 7 times between April, 1955 and August, 1957 (the market topped out in April, 1956). The discount rate was raised 8 times between January, 1973 and early-1974. The market topped out in January, 1973, at the time of the first boost.

The "word" is that this market has already discounted the monetary problems. I doubt it. The fact is that this market has been moving up against an underlying monetary situation that has shattered every previous market in Wall Street annals. And that's why I say that it's simply "not my cup of tea." I consider that one of my prime duties to subscribers is to attempt to safeguard their capital in the same way that I try to safeguard my own. To build assets as an investor, it's NOT necessary to fly with every wind and be in on every advance. But it IS necessary to avoid major losses.

I'll be speaking at two most interesting conferences coming up. The first is the International Investor's Forum, Sept. 14-17, in San Francisco. Among the speakers will be Gerald Ford, William Simon, Robert Bleiberg, Wm. Buckley, Jim Sinclair, Julian Snyder, Nicholas Deak, Arther Laffer and more. Quite a lineup! For info write ICI, 3400 Fourth Ave., San Diego, CA 92103.

The other conference is just as outstanding. It's the fabulous NCMR New Orleans Conference of Nov. 2-5. Among the over 30 speakers will be Tony Boeckh, Franz Pick, Harry Browne, Marty Zweig, Woo Hon-Fai (of Hong Kong gold fame), Robert Bleiberg, Alan Greenspan and Herbert Stein, and many more, a truly amazing list. For info call (504) 865-9919.

NEXT MAILING: September 7th